The international and European environment

Developments in the global economy

Improved global economic outlook

The outlook for the global economy has improved over the past few months. In particular, the risk of a global recession has diminished more and more. This development can be attributed to the continued easing of the situation in the international financial and foreign exchange markets, which was only temporarily interrupted by the crisis in Brazil, and to the persistently strong expansion of economic activity in the United States in the winter half year of 1998-9. According to the most recent IMF forecast, global economic growth will again decelerate slightly in 1999 to an annual average of 2¼%, but as early as next year, it could accelerate to 3½%. Of course, the new optimism regarding economic activity should not obscure the fact that it is still too early to give a final "all-clear" signal. The setback potential remains substantial. The economic outlook must be substantiated by sustained efforts at rehabilitation and modernisation in the respective crisis regions. In addition, the reform efforts in Europe must be kept up.

East Asian emerging economies

One of the positive developments is that the signs of improvement in most East Asian emerging economies are now clearer than before. Over the past year, it was possible to overcome liquidity shortfalls, generate substantial surpluses on current accounts, and, finally, to attract foreign private capital again. In addition, expansionary forces are being fuelled by significant interest rate reductions and a stabilisation of exchange rate developments. Several countries have already been able to halt the decline in industrial output.

Korea has already managed to pull out of its cyclical trough, and overall output is likely to go back up perceptibly this year. However, the weaknesses of many of these countries' financial sectors have not yet been overcome, and the oftentimes high level of corporate debt also stands in the way of a rapid recovery.

Japan

In addition, economic recovery in this region is being hindered by the fact that, in spite of isolated signs of stabilisation, no expansionary stimuli have so far emanated from Japan, which is by far the largest economy in Asia. After the turn of 1998-9, government demand continued to increase at a rapid rate in connection with the implementation of the stimulus programmes adopted in 1998. This, together with an increasing adaptation of stock positions, is likely to have contributed to the improvement of the business climate in the first quarter of this year. However, domestic demand continued to decrease. It seems that industrial capital formation, in particular, has not yet hit bottom. Against this background, the IMF expects overall output to go down once again in 1999. At 1½%, however, the decline is likely to be markedly weaker than last year. The recent sharp rise in share prices on the Japanese stock exchanges indicates that confidence in the country's economic recovery has gone back up. Of course, this has yet to be substantiated in the real economy.

Latin America

The escalation of the crisis in Brazil at the beginning of the year spilled over to other Latin American countries, not so much through the financial markets as through the direct effects on trade. Some of those countries, as major exporters of commodities, had already been weakened by plummeting commodity prices. According to the IMF, the region's real GDP will decline slightly in 1999 but may then grow substantially in the year 2000. For such a rapid turnabout to take place, it will, of course, be necessary for Brazil, as the centre of the crisis, to firmly implement the economic and financial policy measures necessary for a sustainable economic development.

IMF forecasts for 1999 and 2000 *

Item	1997	1998	1999	2000
Real gross domestic product	Change from previous year in %			
Advanced economies 1	+ 3.2	+ 2.2	+ 2.0	+ 2.3
of which				
United States	+ 3.9	+ 3.9	+ 3.3	+ 2.2
Japan	+ 1.4	– 2.8	– 1.4	+ 0.3
EMU	+ 2.5	+ 2.9	+ 2.0	+ 2.9
Inflation rate 2				
Advanced economies 1	+ 2.1	+ 1.7	+ 1.4	+ 1.7
of which				
United States	+ 2.3	+ 1.6	+ 2.1	+ 2.4
Japan	+ 1.7	+ 0.6	– 0.2	– 0.2
EMU	+ 1.7	+ 1.8	+ 1.0	+ 1.4
Unemployment	Number of unemployed as % of the labour force			
Advanced economies 1	7.0	6.9	6.9	6.9
of which				
United States	4.9	4.5	4.5	4.7
Japan	3.4	4.1	4.8	4.9
EMU	12.3	11.7	11.3	11.0

* Source: IMF, World Economic Outlook, May 1999. — 1 Industrial countries plus Israel, China (Taiwan), Hong Kong (Special Administrative Region), Republic of Korea and Singapore. — 2 Measured by the consumer price index.

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Central and eastern Europe

After the extremely sharp downturn in production witnessed in Russia last year, overall production now seems to have increased slightly over the past few months. However, the overall economic situation remains critical, as the country's significant structural problems, especially the desolate situation of the government budgetary positions, the weak financial position of many enterprises and the overall negative payment behaviour, have not been tackled forcefully enough. The outlook for the other countries closely linked to Russia by means of foreign trade, such as Ukraine and Belarus, is also extremely unfavourable. The crisis in Russia did not have lasting adverse effects on the driving economic forces in the central European countries in transition and the Baltic states, but the pace of growth in these regions has slowed perceptibly, not least as a result of the slowdown in economic activity in western Europe. It is not yet possible to accurately evaluate the negative economic effects of the Kosovo conflict on the neighbouring countries, evident above all in the interruption of transportation routes and income losses in tourism.

United States

The US economy is currently the mainstay of global economic activity. According to preliminary figures, real GDP increased by 1%, in seasonally adjusted terms, in the first quarter of 1999 and was thus 4% up on the year. This strong expansion was boosted by all components of private final demand. Private consumption was particularly buoyant, exceeding its already high level in the previous quarter by just over 1½%. For one thing, consumer demand was fed by renewed sharp growth of disposable income. For another, private households stopped using their current income for savings owing to the continued capital appreciation of existing portfolios, tending to withdraw assets slightly instead; the saving ratio fell to – 0.5%, thus reaching its lowest level, on a quarterly average, since the beginning of statistical documentation in 1946. GDP growth was curbed by a marked decline in exports (– 2% in seasonally adjusted terms compared with the previous period) and a simultaneous strong increase in imports. As a result, the foreign trade deficit reached a new record high, in terms of the real balance, of 4% of GDP. According to the IMF forecast, overall output in the United States could go up by 3¼% this year, following an increase of 4% last year. Next year, the growth rate in the US is expected to slow down to 2¼%, owing, *inter alia,* to the fact that assets cannot be expected to increase at the same rate as in the past few years.

General economic trends in EMU

Economic slowdown in the winter half year

Economic development in EMU has slackened significantly since last autumn. In the last quarter of 1998, real GDP was only ¼% above the level recorded in the previous quarter in seasonally adjusted terms and 2¼% higher than a year earlier. After the turn of 1998-9, the economy slowed down even further. As an average of the first two months of 1999, industrial output (excluding construction) – data on overall economic output in EMU is not yet available – was ½% down on the already low level of autumn 1998 in seasonally adjusted terms. Of course, this level is still ¾% higher than in the same period last year. The decline in unemployment slowed in the winter half year; in March the seasonally adjusted unemployment rate was 10.4%. The fact that capacity utilisation in manufacturing did not decline further between January and April and the recent slight improvement in the business climate in industry are positive signs. However, there are not yet any clear signs that growth in EMU will accelerate sharply in the near future. One must bear in mind that the slowdown in growth is particularly affecting Italy and Germany, whereas other member states, such as Ireland, Portugal and Spain, which have "profited" considerably from the interest rate convergence process in the run-up to EMU, continue to exhibit relatively strong growth.

Dampened outlook for growth in 1999

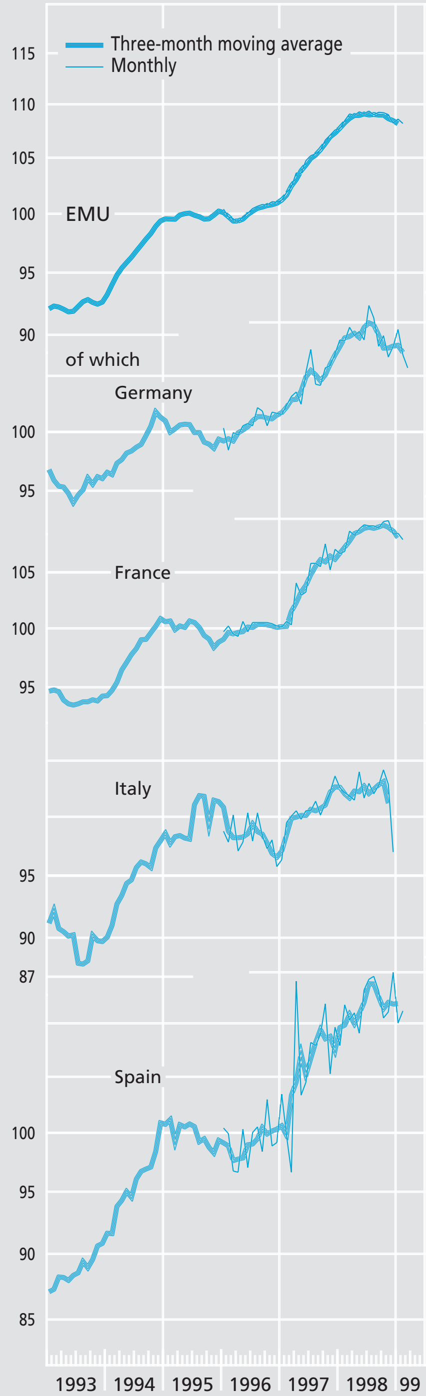
Up to now, domestic demand has not been able to assert itself, having itself come under the impact of dampening effects from outside in spite of the fact that exchange rate pressure on the euro area, unlike the pressure on the US economy, has eased. Investment activity, in particular, was sluggish as a whole in spite of extremely positive underlying monetary conditions. This is one of the reasons why the outlook for growth in the euro area has dampened further for 1999, with the result that the international organisations have significantly revised their forecasts for growth downward to between 2 % and 2 ¼ %. Owing to the existing time lags, the stabilisation tendencies observed in the international environment in the past few months will only gradually lead to an increased growth in exports in the industrialised countries in general, and in the member states of EMU in particular.

Exports from the euro area to third countries

At all events, in the first few months of 1999, exports from the euro area to third countries continued to suffer from the after-effects of the worldwide crises which had led to a sharp downturn in export activity in the euro area

Industrial output *
in the euro area

1995 = 100; seasonally adjusted; log. scale



* Including mining and energy, excluding construction. — Sources: Eurostat, national statistics.

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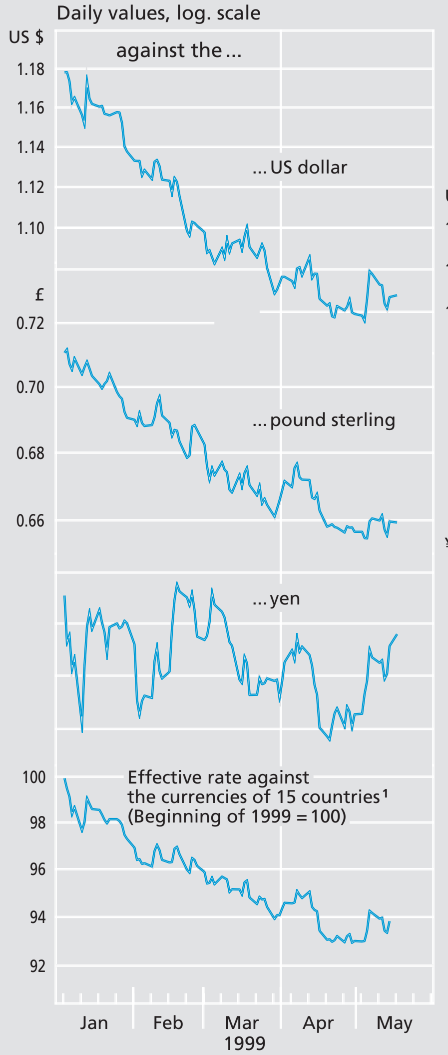
Exchange rate of the euro

Daily values, log. scale



1 BIS calculations based on weighted averages of the euro exchange rates.

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countries last year. As a result, in the first two months of this year exports were down more than 8 % from the same period a year before, compared to approximately 4 % in the last quarter of 1998. However, isolated signs indicate that following the sharp decline in foreign business, the European economy might have finally hit bottom and may, in the near future, begin to recover slightly.

Imports to the euro area from third countries

In line with the enduring slump in exports, imports to the euro area from third countries have also decreased distinctly. The competitive pressure on euro area enterprises being exerted over the course of the past year by increasing competition, especially from the crisis-ridden regions in Asia in the field of imports, does not seem to have intensified. In the first two months of the year, the value of imports fell to 7 ½ % below the level recorded a year earlier, whereas in the previous quarter, the decline had amounted only to 1½ %. The development of import turnover was strongly influenced by the markedly downward trend in import prices up to the beginning of the year; however, this trend has not continued at the same rate in the recent past. Nonetheless, the value of goods purchased by euro area countries from third countries has probably for the first time fallen below its previous year's level.

Dollar on the rise

The current exchange rate developments could also help stabilise foreign trade. The favourable economic situation in the United States has gone hand in hand with a significant strengthening of the dollar against the euro. In addition, the Kosovo conflict has probably also contributed to the rise of the dollar. As a result, after initially following a more positive trend, the exchange rate of the euro fell by almost 8 %, from $ 1.17 to $ 1.07 as this Report went to press. Expressed in Deutsche Mark, this meant that the dollar reached a high of DM 1.85 and is thus equal to the rate of April 1998, when the dollar reached its peak of last year. In the wake of the US dollar, the pound sterling and several Scandinavian currencies have also appreciated against the euro since the beginning of the year.

Japanese yen also appreciated

Since the beginning of this year, the yen has also strengthened against the euro, namely by 1 %. The situation has also improved considerably in most emerging economies. This has lead to a certain correction of the exchange rates of their national currencies, which had previously depreciated substantially.

Effective euro exchange rate

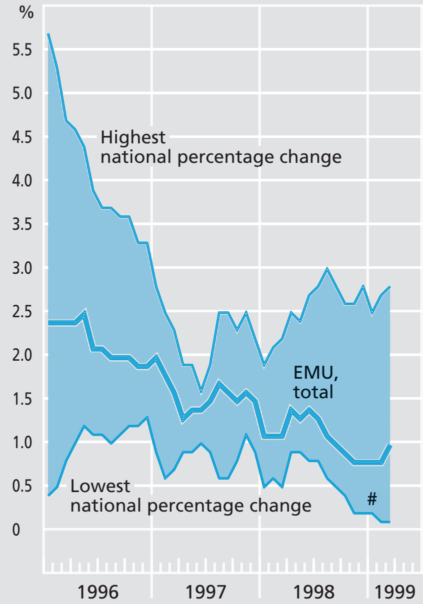
As a weighted average, the exchange rate of the euro against the currencies of 15 industrialised and developing countries was down approximately 5 ½ % from the beginning of the year as this Report went to press. In real terms, i. e. taking into consideration the differences in price movements, the decline of the euro was about the same. From the exchange rate angle, the competitive strength of the suppliers in the euro area has thus improved significantly over the past few months. The rise and fall of the exchange rates among the major global currencies in connection with business and interest rate cycles is currently making it easier for the euro area countries to use the improved opportunity for growth in the foreign markets without any perceptible increase in inflationary risks. Quite apart from this, it remains of paramount importance that the euro wins the lasting confidence of the international markets.

Consumer prices

Consumer price inflation in EMU increased somewhat lately under the impact of rising crude oil prices and the weakening trend of the euro. However, the increase remained within the margin deemed by the Eurosystem to be compatible with the objective of price stability. In the somewhat longer term, as well, there are no particular indications of inflationary dangers. Measured in terms of the Harmonised Index of Consumer Prices, inflation rose to 1.0 % in March after remaining at 0.8 % during the previous four months due, *inter alia,* to extremely low oil prices. However, it should be noted that there was a wide spread in the inflation rates. Whereas inflation remained clearly below average in Germany, France and Austria, it was considerably higher in some of the countries with a more positive economic development.

Consumer prices in EMU *

Change from previous year in %



* Measured by the Harmonised Index of Consumer Prices. — # January excluding Luxembourg (-1,4%).

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Monetary policy and financial markets in EMU

Interest rate cut in April

After following a straight path with regard to interest rate policy in the first three months of stage three, the Governing Council of the ECB cut its interest rate on April 8. The interest rate on the main refinancing operations, which continued to be conducted as fixed rate tenders under pre-announced conditions, was lowered from 3.0 % to 2.5 % with effect from April 14, and the interest rates on the marginal lending facility and the deposit facility were reduced from 4.5 % to 3.5 % and from 2.0 % to 1.5 %, respectively, with effect from April 9; since then, the interest rate corridor for the overnight interest rate has been situated symmetrically around the main tender rate. The interest rate reduction was conducted with future economic developments in mind and in line with the Eurosystem's monetary policy strategy. Neither monetary developments nor other indicators imply a danger of inflation in the foreseeable future. The interest rate decision will keep monetary policy on a longer-term stability-oriented course and will thus contribute to the creation of an economic environment in which the considerable potential for growth of the EMU countries can be fully exploited.

Decline in money market rates

The trend in interest rates on euro futures contracts (EURIBOR) had been pointing downward since the beginning of March, thus partly anticipating the interest rate decision of April 8. In mid-May, they were about ½ percentage point lower than the level recorded at the end of February. The same is true of the overnight interest rate as measured by the EONIA, which was characterised by relatively volatile trends between February and April.

Liquidity management through main refinancing operations

This development was also influenced by major and often unexpected changes in the factors determining market liquidity, especially in the deposits of public authorities with the Eurosystem, which could not always be offset promptly through the weekly conclusion of main refinancing operations. In addition, since March the Eurosystem has been attempting to bring the fluctuation margin for the overnight interest rate, which has always been higher than the main refinancing rate, closer to the official money market rate. It has been trying to do this by supplying liquidity as early and as abundantly as possible with the aim of counteracting the increasing number of bids in the fixed rate tenders and the concomitant decline in allotment ratios. Finally, at the beginning of April, increasing expectations of an interest rate cut led to a perceptible decline in the amount of bids submitted in the main tender, temporarily resulting in a considerable shortage of liquidity in the banking system in spite of the fact that all bids were fully allotted.

Longer-term refinancing operations

The total volume of the longer-term refinancing operations was set at € 45 billion for the first three months of 1999. In April, the Governing Council of the ECB decided to retain this amount for the following six months. Starting in March, these operations, which are always conducted as variable rate tenders, were carried out using the multiple rate auction procedure instead of the more market-oriented single rate procedure previously used.[1] All in all, the Eurosystem has increased the volume of its open market operations by € 36.3 billion to a total of € 175.1 billion (see table on page 24), compensating market-induced withdrawals of funds amounting to € 2.7 billion and amounts due for repurchase from the overhang of monetary policy transactions in stage two amounting to an average of € 30.6 billion.[2] So far, the Eurosystem has not conducted any short-term fine-tuning operations.

Standing facilities

Recourse to both the marginal lending facility and the deposit facility was mostly modest except for the last days of the maintenance period. The standing facilities were utilised mainly by German credit institutions.

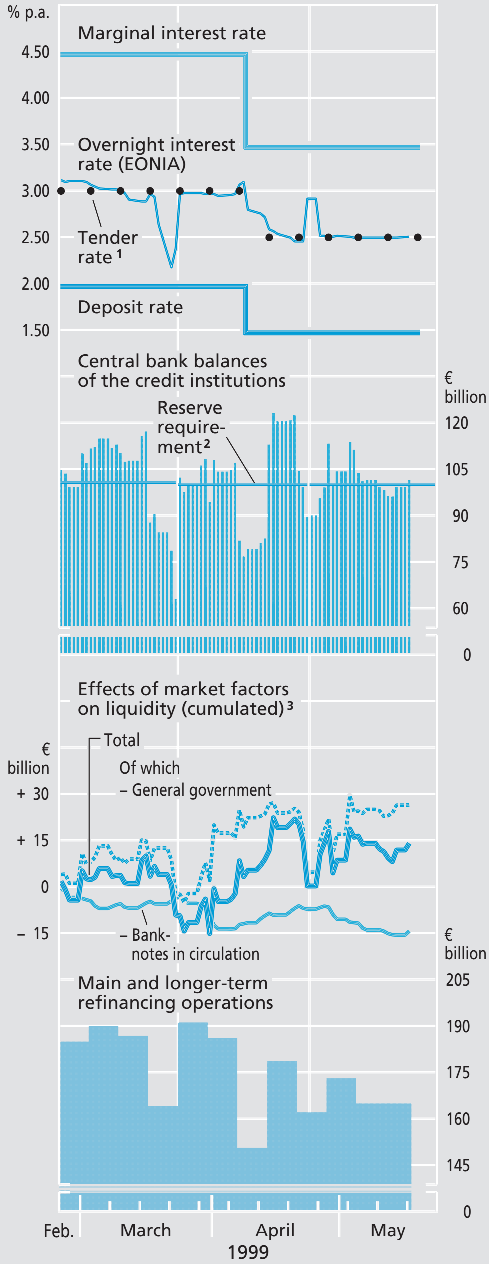
Monetary growth slightly above the reference value

The money stock M3 grew at a relatively strong rate in the euro area in the first quarter of 1999. This was mainly attributable to a strong increase in January; in February and March, monetary expansion was more subdued. The 12-month growth rate of the monetary stock M3 was 5.1% in both February and March, compared with a rate of 5.4% in January.[3] The latest three-month moving average of the 12-month growth rates stood at 5.2% and was thus slightly higher than

1 In the single rate auction procedure, the allotment interest rate applied to all satisfied bids is equal to the marginal interest rate. In the multiple rate auction procedure, the allotment interest rate equals the interest rate offered in each individual bid.
2 See the table on page 24 on the development of the major factors determining bank liquidity in the two maintenance periods from February to April. The indicated increase in net foreign reserves in March/April mirrors, *inter alia,* valuation adjustments, which the Eurosystem always carries out at the end of a quarter. To "neutralise" liquidity, these effects are recorded as counterentries on so-called revaluation accounts which are recorded here as "Other factors".
3 Unless indicated otherwise, the growth rates are year-on-year comparisons.

Interest rate movements and liquidity management in the Eurosystem

Daily values



1 Interest rate for main refinancing operations. — 2 Maintenance periods: February 24 to March 23, March 24 to April 23, and April 24 to May 23, 1999. — 3 Banknotes in circulation, net general government position vis-à-vis the Eurosystem, net foreign currency reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances.

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Factors determining bank liquidity *

€ billion;
calculated on the basis of daily averages
of the maintenance periods

Item	1999 Feb. 24 to March 23	March 24 to April 23	Feb. 24 to April 23
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	+ 2.4	– 4.0	– 1.6
2. Change in general government deposits with the Eurosystem	– 8.8	+ 7.0	– 1.8
3. Change in net foreign exchange reserves 1	– 4.6	+ 14.8	+ 10.2
4. Other factors	+ 4.5	– 14.0	– 9.5
Total	– 6.5	+ 3.8	– 2.7
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 31.8	– 6.3	+ 25.5
b) Longer-term refinancing operations	+ 10.8	– 0.0	+ 10.8
c) Other operations 2	– 30.6	–	– 30.6
2. Standing facilities			
a) Marginal lending facility	– 3.4	+ 0.3	– 3.1
b) Deposit facility (increase: –)	– 0.1	+ 1.1	+ 1.0
Total	+ 8.5	– 4.9	+ 3.6
III. Change in credit institutions' current accounts (I. + II.)	+ 2.0	– 1.1	+ 0.9
IV. Change in the minimum reserve requirement (increase: –)	– 2.3	+ 0.6	– 1.7
Memo items: 3			
Main refinancing operations	136.4	130.1	130.1
Longer-term refinancing operations	45.0	45.0	45.0
Other operations 2	–	–	–
Marginal lending facility	0.4	0.7	0.7
Deposit facility	1.4	0.3	0.3

* For longer-term trends and the contribution of the Deutsche Bundesbank see pages 12* and 13* in the Statistical Section of this Report. — 1 Including end-of-quarter valuation adjustments with no impact on liquidity. — 2 Including monetary policy operations concluded in stage two and still outstanding at the beginning of stage three; excluding outright transactions and the issue of bonds (included in item I.4.). — 3 Levels on an average of the respective reserve period.

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the reference value of 4½%. When interpreting these figures, however, one must take into account that the money stock was probably bloated somewhat at the beginning of the year owing to special factors in connection with the transition to stage three. Thus, no inflationary risks are present from the monetary angle.

Components of the money stock

In the first quarter of 1999, the dynamism and profile of monetary growth were influenced above all by overnight deposits, which increased at an annual rate of 13.1% in March. The sustained and exceptionally strong growth of overnight deposits is probably attributable for the most part to the low interest rates and largely stable prices. In January, investors' preference for liquidity was apparently also fuelled by uncertainty in connection with the transition to monetary union and by increased volatility in the financial markets. Money market fund certificates and money market paper as well as deposits redeemable at up to three months' notice also grew considerably. By contrast, the development of the other components of the money stock M3 was moderate.

Counterparts in the balance sheet

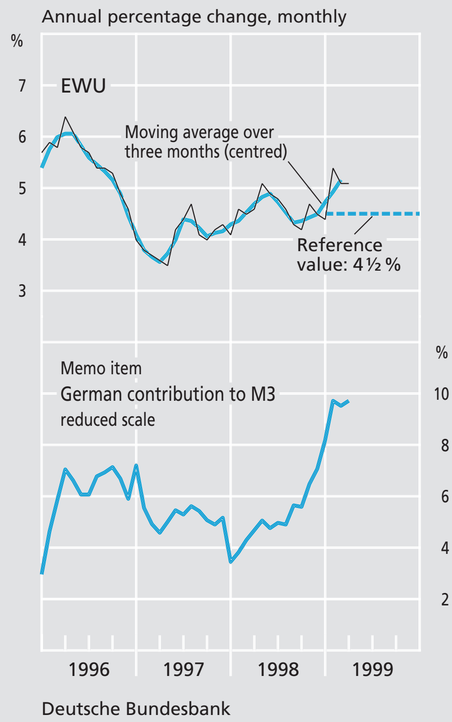
Regarding the balance-sheet counterparts of M3, monetary growth in the euro area was boosted in particular by the growth in credit to the private sector (9.7%). Both holdings of shares (22.8%) and advances extended by Monetary Financial Institutions (MFIs) to enterprises and households (9.6%) exhibited strong growth. The growth in advances is likely to have been influenced in particular by the historically very low level of bank interest rates and the rather strong increase in land

and housing prices, which was fairly pronounced in some countries. The overall economic conditions in the euro area, the elements of which are rather heterogeneous, could have had similar effects. Thus, it is likely that in countries exhibiting sustained strong economic growth credits were taken up for investment financing. In countries where economic conditions have recently clouded, however, credits were probably taken up to finance involuntary stockbuilding. The amount of credit granted by the MFIs to public authorities has increased very slowly (1.7 %) in the past twelve months. Monetary capital kept with the MFIs has been growing at a rather slow rate (3.9 %) for some time now and has thus contributed only little to slowing the pace of monetary growth. In the payment transactions of non-MFI euro area residents with counterparties outside the euro area, outflows of funds were recorded in the first quarter of 1999. The net external asset position of the euro area MFIs, in which such transactions are reflected, declined by € 75.4 billion. This might have been associated with the fact that direct investment and portfolio investment by enterprises and individuals in the non-euro area apparently remained strong.

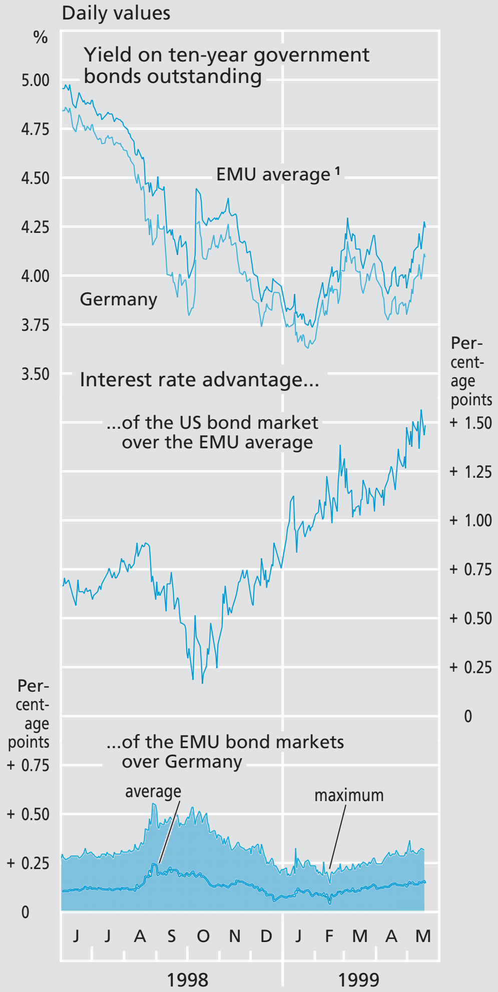
German contribution

The German contribution to the growth of M3 in the euro area increased at an annual rate of 9.8 % and thus more rapidly than the EMU aggregate. The increase in the growth rate has been particularly pronounced since December 1998. For one thing, this had to do with a substantial increase in credit to the private sector in connection with changes in tax regulations concerning investments in eastern

Growth of the money stock M3 in EMU



Germany. In the past 12 months, advances by German MFIs to enterprises and individuals in the euro area grew by just under 8 %, remaining below the growth rate recorded in the euro area as a whole. For another, monetary growth in Germany was recently boosted also by repatriations of funds which German non-banks had deposited for a short time with foreign branches of German banks – especially in Luxembourg and London. The cause for this may have been the decision to pay interest on minimum reserves, which has made the interest rates on short-term deposits with German credit institutes more attractive. In line with this development, deposits having an agreed maturity of up to two years have increased sharply of late (14 %). To the extent that funds were repatriated to the domestic banking system from Luxem-



1 Weighted average yield on ten-year government bonds of the EMU member countries; GDP-weighted.

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bourg, the repatriation is offset in the euro area aggregate.

Capital market rates remain low

The capital market rates in the euro area remained low this spring. At the beginning of the year, the smooth transition to stage three triggered substantial portfolio shifts to the euro area and contributed to a further decline in yields. The escalation of the currency crisis in Brazil and the associated renewed flight to "safe havens" had a similar effect. At the end of January, the yields on ten-year government bonds issued by EMU countries reached a new all-time low of 3 ¾ % on average. In the wake of rising interest rates in the US capital market, they temporarily increased by almost ½ percentage point in February. Subsequently, however, the slowdown in economic growth in monetary union led to a renewed decline, and following the Eurosystem's interest rate cut at the beginning of April, the yields again fell below 4 %. On balance, the interest rate gap vis-à-vis the US bond market has widened substantially. In mid-May, yields in Europe again came under the influence of the US market, where burgeoning fears of inflation had led to a sharp increase in interest rates. At about 4 ½ %, however, the most recent figure for ten-year government bond yields in the euro area is still approximately 1½ percentage points below the yields on comparable US paper.

Widening yield spread

The interest rate pattern among the various countries participating in EMU has hardly changed this spring. The yield spread of ten-year government bonds in the partner countries over Federal bonds was never higher than just over ¼ percentage point. By contrast, the yield spread between the money market and the capital market in the euro area has widened considerably. In mid-May, ten-year yields were almost 1 ¾ percentage points higher than the three-month EURIBOR, compared with only ½ percentage point at the beginning of the year. This is primarily attributable to the decline in money market rates. Apparently, the Eurosystem's lowering of interest rates in April did not lead to a fundamental reassessment of the inflation expectations mirrored in the capital market rates. Rather, the interest rate cut was regarded by the market participants as in line with stability.

Rising share prices

Share prices in the EMU countries, which continued to be characterised by strong volatility, grew at a modest rate this spring. Over the period from the end of 1998 to mid-May 1999, share prices as measured by the EURO STOXX share price index increased by around 4 %, remaining below the increase recorded in the US share market in the same period (9 %). Initially, the European share markets were stimulated by the successful launching of the euro. In the first week of the year alone, the EURO STOXX index rose by almost 7 %, but subsequently declined somewhat. In the following months, the increase in capital market rates (in February and mid-May) and the Kosovo weighed particularly on the European share markets. The slowdown in economic activity and the uncertainty in several EMU countries with regard to economic policy also led to divergent developments in the national share markets and in individual sectors. German share prices, for example, only rose at an average rate of less than 2 % over the period from January to mid-May, compared with an increase of about 8 % in France.